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CURRENT INDIVIDUAL LIFE INSURANCE TOPICS

Moderator: HARRY WALKER.
Panelists: WALTER N. MILLER, NEAL N. STANLEY.

1. Current developments in variable life insurance.

2. Section 79 products.

3. Policy loan interest rate.

4. Term insurance.

MR. HARRY WALKER: We find ourselves now in the position of: (1) the SEC having adopted so-called Rule 3c-4 in January 1973, exempting variable life insurance (VLI) from the Investment Company Act of 1940, the exemption being subject to the states promulgating regulations that would afford the public material protections substantially equivalent to the relevant protections of the 1940 Act; (2) the NAIC proceeding to adopt a Model VLI Regulation that was intended to be responsive to Rule 3c-4; (3) followed by the SEC, in 1975, withdrawing Rule 3c-4.

It is, therefore, appropriate to reexamine the Model VLI Regulation adopted by the NAIC, with particular reference to the following provisions that were included either to be responsive to Rule 3c-4 or to assure the SEC that there would be uniform state regulation in those areas with which the federal securities regulation is concerned:

(a) Requirement that state of domicile of a company desiring to do a VLI business in another state have substantially the same requirements as to permissible investments and as to change in investment policy.
(b) Specific provision dealing with suitability.
(c) Requirement that insurance be for the whole of life. This, for example, excludes endowments, an exclusion that makes sense if VLI is to be completely exempted from the 1940 Acts.
(d) Requirement that the death benefit never be less than the initial face amount of insurance - one of the conditions suggested by the industry in its application for exemption from the 1940 Acts.
(e) The so-called "minimum multiple" requirement - that the death benefit be at least a specified multiple (varying with issue age) of the annual premium - e.g., this would prohibit a premium greater than $30 per thousand at issue age 35. The minimum multiple rule was suggested by the industry as a condition for exemption from the 1940 Act, to minimize the investment aspects of a policy exempted from the Act.
(f) An extremely complicated provision requiring an increase in cash values, specified by formula, whenever premiums exceeded a certain level. There is no such requirement in state laws for fixed life insurance, and this provision was intended to be responsive to Rule 3c-4's expectations that state regulation would provide protections against excessive sales, administrative and management charges.
(g) A mandatory privilege of exchange from variable to fixed life insurance within 18 months of issue - originally designed as the counter-

part of the right under the 1940 Act to receive a return of a portion of the sales load under front-end loaded periodic payment plans surrendered within 18 months.

(h) A provision establishing an elaborate system of procedures and hearings to effect a change in the investment policy of the separate account. Now, however, changes in investment policy are subject to the requirements of the Investment Company Act of 1940, requiring the vote of policyholders, making public hearings unnecessary. The provision also gives a policyholder who objects to a material change in investment policy, the right to exchange his policy for fixed life insurance.

(i) A provision specifying a maximum percentage of assets that can be deducted as a charge for investment management and mortality and expense guarantees, intended as another response to Rule 3c-4's expectation that state regulation will provide protections against excessive sales, administrative and management charges.

(j) A "free-look" provision running to the later of 10 days from delivery of the policy or 45 days from the date of application.

Following the withdrawal of the 3c-4 exemption, The Equitable Life Assurance Society of the United States and its wholly-owned subsidiary EVLICO (Equitable Variable Life Insurance Company) filed an application for certain exemptions from the Investment Company Act of 1940, exemptions that in our view were needed to make the marketing of the product viable. The Order of Exemption was granted by the SEC in October of 1975, and our registration under the 1940 Act became effective in December of 1975. The principal exemptions requested dealt with "sales load" and voting rights of policyholders. In our application for exemption, we intended to comply with Section 27(h) of the 1940 Act permitting a maximum 1st year sales load of 20%, with an average sales load of 9% over a reasonable period, to avoid the requirement (under Section 27(d) permitting a higher 1st year sales load) of a refund of a portion of the sales load if the policyholder decided to surrender his contract within 18 months after issue.

We have consistently maintained in our discussions with the SEC that a life insurance premium is indivisible, the entire premium being designed to pay over the lifetime of the contracts for sales expenses, administrative expenses, benefits, and with a margin for contingencies. Nevertheless, in our application for exemption, for this purpose only, we defined sales load along the lines of the 1940 Act definition, viz., the excess of the premiums over the sum of (a) the cost of insurance (based on the 1958 CSO table), (b) the increase in cash value each year not attributable to investment earnings, (c) a reasonable charge to cover the minimum death benefit guarantee, (d) a deduction for administrative expenses and state premium taxes. We further designed our contracts so that the sales load so defined was 20% in the first year, and averaged out at 9% over a period of 20 years, or the life expectancy if shorter.

In December of 1975 the SEC proposed, and invited industry comment on, a Rule 6e-2 which would grant certain exemptions from the 1940 Act for those companies that wished to enter this market. The proposed Rule 6e-2 deals with Section 27(d) rather than 27(h) of the 1940 Act. It defines sales load along the lines of the EVLICO definition but would grant greater leeway than requested by EVLICO. As in the case of the EVLICO exemption, it would restrict the voting rights of policyholders, recognizing that under a VLI policy, because of the minimum death benefit guarantee, the company assumes a material investment risk.

The industry has responded to the proposed 6e-2 rule by requesting greater latitude as to the portion of the sales load that could be retained if the policyholder surrendered his contract within a specified period after issue. It is expected that the SEC will release a 6e-2 rule in the near future.

As for state regulation, the industry, at the forthcoming meeting of the NAIC, will propose certain changes in the NAIC Model VLI Regulation, in the light of the fact that exemptive Rule 3c-4 has been withdrawn.

Viability of VLI depends on a truly cooperative form of dual regulation if SEC continues to assert jurisdiction. There is no way to isolate completely the investment from the actuarial and insurance aspects of this product.

The SEC has not objected to emphasis being placed on the insurance nature of VLI. EVLICO's prospectus states that "The Policies are designed to provide lifetime insurance coverage. They are offered primarily as a protection against the economic loss resulting from the Insured's death and not as an investment. The Policies are not similar to a systematic investment plan of a mutual fund."

EVLICO's VLI policies have now been approved in 14 states, and we are selling in those states.

MR. WALTER N. MILLER: One interesting practical effect of this emerging pattern of SEC regulations is that, in effect, under VLI your cash value has to equal your reserve. The traditional fixed dollar concept that, during earlier policy years, cash values should equal reserves minus an allowance for unamortized acquisition expenses is out the window under this pattern of regulation. Cash values have to equal reserves under VLI, although not necessarily net level premium reserves. As a matter of fact, EVLICO's product is based on a modified reserve system, but there are constraints here, too. For example, a full CRVM reserve method would not be admissible under the current pattern of SEC regulations, because you would then find yourself in violation of the first year sales load maximum, even under the 27(d) treatment.

MR. WALKER: The limitation to a 20% first year sales load necessitated that we completely redesign our policies from what we had originally planned back in 1973. Our new design provides for a cash value in the first year, because the sales load is defined as the remainder after you deduct from the premium what goes into the cash value plus the cost of insurance plus administrative expenses. We therefore ended up with a first year cash value that is relatively high. Our original design, which assumed an exemption from the 1940 Act,involved a 55% first year commission with no first year cash value.

I should mention that we are currently selling two types of VLI contracts. The first has a minimum death benefit equal to the initial face amount. The second has a minimum death benefit that increases each year by 3% until the minimum equals 150% of the initial face amount. Of course, the actual death benefit in a given year may be greater than the minimum benefit.

MR. MILLER: One other comment I would like to offer is that, because EVLICO's VLI products are non-par, their registration and negotiations with the SEC had nothing to do with whatever problems might be caused by issuing VLI on a participating basis. After some discussions with the industry, the SEC's

currently proposed Rule 6e-2 does contain what I believe is a reasonable treatment, appropriately recognizing the nature of participating insurance and recognizing the fact that, other things being equal, a participating premium rate is necessarily going to be higher than a non-participating rate for corresponding coverage.

MR. NEAL STANLEY: I am listing in sequence the events of which I have knowledge that Congress or the Treasury has publicly promulgated with respect to Section 79.

(1) Congress passed Section 79 of the Internal Revenue Code. The Act simply says that all payments made by an employer for insurance on the life of an employee are to be included in the gross income of that employee except for $50,000 of group-term life insurance. Section 79 does not define group-term life insurance.

(2) Section 1.79 - This regulation was issued by the Treasury and presumably answered the question,"What is Group-Term Life?" Ten year's silence on the part of Congress would seem to indicate that it concurs with these regulations.

(3) Revenue Ruling 70-162 interprets Section 79 and the regulations under Section 1.79. This ruling concluded that an employer can have only one plan of group-term life, not one plan for employees under 50 and another plan for employees over 50.

(4) Revenue Ruling 71-360 deals with the allocation of a premium into a term element and a permanent element where a single policy provides both types of coverage. The broad conclusions were:

(A) That the allocation must be in the policy.
(B) That the premium per $1,000 for term insurance must increase by attained age and be determined by realistic assumptions with respect to interest, mortality and expense.
(C) Dividends or rate credits arising from the term insurance must not be allocated to the permanent insurance.
(D) If the term element includes any portion of expense properly allocable to the permanent portion,then all employer contributions are disqualified and any contributions made by the employer are not excludable from the gross income of the employee.
(E) In order for the premium to be properly allocable, the two premiums must be independent of each other to the extent that equivalent insurance might be obtainable under separate contracts.

(5) Revenue Ruling 71-567 deals with evidence of insurability. Section 179-(1)-(b)-I-(iii)-(d) says that, if at least 10 or more lives are covered under a plan of group-term life insurance, coverage must be offered to all employees in a given class, such class to be determined on a basis which precludes individual selection. If the group covers less than 10 lives, then it must cover all lives, or, if it does not cover all lives, an individual life must not be excluded based on evidence of insurability which includes a medical examination or other evidence not obtained solely on the basis of a medical questionnaire completed by the employee. It is the eligibility for participation and the amount of insurance that must not be affected by such use of medical examinations or other outside sources of underwriting information.

This Revenue Ruling 71-567 deals with a plan involving 40 lives. Under this plan evidence of insurability is used to determine eligibility and amounts. This ruling states that larger plans covering 10 or more employees may require other evidence of insurability, including medical examinations. The ruling repeated the prohibition of the use of medicals for the purpose of determining eligibility or amount for a plan involving less than 10 employees.

(6) Revenue Ruling 75-528 says that, where a medical examination is used for the purpose of lowering individual premiums after a group involving less than 10 lives has been issued at a higher premium, such use of medicals disqualifies the plan. This ruling is the first introduction of premium as an element. The regulations and the previous Revenue Ruling 71-567 discusses the use of evidence for the purpose of determining eligibility to participate in the plan and the amount of insurance to be provided the employee. There is no reference in the Code, the Regulations, or in any other revenue ruling with respect to the use of medicals for the purpose of determining the premium to be charged for group-term life insurance.

(7) In addition to the published rulings, numerous private rulings have been issued to individual taxpayers concerning the tax treatment to be accorded individual plans of group-term life insurance.

So much for the legislative and regulatory history of Section 79. I would now like to discuss the industry actions which gave rise to the revenue rulings and the industry response to such rulings.

Prior to Section 79, the 1959 edition of "Tax Facts" says that premiums paid by an employer on Group-Term Life Insurance are not taxable to the employees. It cites Revenue Ruling 54-164. The 1964 "Tax Facts" mentions Section 79 for the first time. It appears that the purpose of Section 79 was not to make premiums on group-term life insurance excludable from the income of the employee. They were already excludable under Revenue Ruling 54-164. Rather the purpose of Section 79 was to limit the exclusion to a maximum of $50,000. Therefore Section 79 was considered by Congress to be a loophole closing device in response to the sale of large size policies of group-term insurance on the lives of corporate executives.

I asked our legal department what the definition of group-term life insurance had been prior to Section 79, but found that nobody seemed to know. I dug up a paper by Peter D. Cooper, of Occidental Life, and he says that prior to Section 79 the applicable law was issued by the Treasury Department, in Law Opinion 1014. They concluded that, while premiums paid for group life insurance constitute proper deductions as ordinary and necessary expenses, they do not constitute additional income to the employees whose lives are insured. They reached this conclusion by reasoning that "the values of the benefit received by the employee from the group insurance protection are too vague and too contingent to be treated as taxable income. The employee realizes only an amorphous feeling of contentment, while the employer, rather than paying additional compensation in making premium contributions, is merely investing in increased efficiency."

Things then went smoothly until the industry began to market in rather large quantities an individual whole life plan involving a split of the whole life premium into a term element and permanent element. This same concept was also used with group permanent insurance. The split was such that a level portion of the premium was labeled "Term Insurance" and paid for by the

employer and the balance of the whole life premium was labeled "Permanent Insurance" and paid for by the employee. It was felt that, if the employer paid no part of the premium labeled "Permanent Insurance," the portion labeled "Term Insurance" if paid for by the employer was excludable from the gross income of the employee under Section 79. Revenue Ruling 71-360 deals with this phase of the development of the Section 79 product.

Because of Revenue Ruling 71-360 we, at Republic National, developed the Dual Policy concept. In previous papers I have discussed the development of this product. It was my conclusion at the time Revenue Ruling 71-360 was released that the dual policy concept was the only concept that could clearly meet all of the objections raised by Revenue Ruling 71-360. In other words the issuance of two separate contracts, either of which could be renewed separately, settled the problems of allocation in the policy, premiums per $1,000 increasing by attained age, employer paying no portion of premium properly allocable to permanent insurance, etc. The test of commercial marketability is so conclusive that I never had any doubt, and still have no doubt, that the dual policy concept complies with Section 79, the Regulations, and Revenue Ruling 71-360.

A return to a single policy allocation has emerged as a result of a policy recently developed. This policy is an increasing permanent basic policy with a decreasing term rider. The premium for the rider is said to qualify as group-term life insurance under Section 79. The allocation of the premium to the term rider is very heavy in the first two years under the contract, based on the philosophy that the value to the employee of permanent insurance is essentially the discounted value at 6% interest of the increase in cash value and that the balance of the whole life premium is properly allocable to term insurance. The term rider does not appear to be severable, and indeed if the term rider were severed, the deficiency reserves on the remaining permanent policy would be enormous.

It is not at all clear how such a policy meets the test of proper allocation defined by Revenue Ruling 71-360; however several companies, including my own, have received private rulings which state that the allocation is proper.

Finally, in the last two months I have seen policies issued by large well-known companies which are nothing but rate-book whole life policies with an endorsement in the front allocating the whole life premium into a term element and a permanent element; thus we have come full circle and are right back where we were prior to the issue of Revenue Ruling 71-360.

My present conviction regarding this market may be summarized as follows:

(1) I am convinced that Congress intends that the employer may contribute the premium for up to $50,000 of group-term life insurance on the life of an employee without including such contribution in the taxable income of the employee. Congress intends that this exclusion from income be available to all employees, not just the employees of large corporations.

(2) The only practical way to make such exclusion available to employees of small corporations is to market permanent insurance so structured that a portion of the premium can qualify as group-term life under Section 79. It is not economically feasible to sell pure group-term life to small employers.

(3) Any regulatory rulings which inhibit the sale of reasonable amounts of properly allocated group-term insurance to small employers are not in the public interest and are not consistent with the intent of Congress.

MR. GEORGE W. SHELLY: I have found that what you know about Section 79 seems to depend upon when you learned it. Our policy is a regularly marketed whole life product. The cash value is allocated to permanent insurance, the net amount at risk, if you will, is called "group term", and the permanent premium allocation is essentially the accumulation required to build up to the cash value each year at interest. For a policy where the cash value is zero the first year or two, the entire premium goes to group term insurance in those years. In contrast, Ruling 71-360 requires that the rate per thousand increase with attained age. Clearly, in this case, you have a large term premium in the early years which tapers off and therefore does not increase with attained age. The response of the actuaries of the IRS has been that the 71-360 ruling is obsolete, but it is still a published ruling.

MR. STANLEY: I think they have an allocation philosophy which simply says that the value to the employee of permanent insurance is simply the cash value. Therefore, this should be the taxable income to the employee if the employer pays the entire premium. I cannot square that with Revenue Ruling 71-360.

MR. SHELLY: I am concerned, because ten years down the road Ruling 71-360 will still be there, but some of the actuaries at the IRS may not.

MR. WALKER: George, is it possible that at some time in the future, in order to avail yourself of the Section 79 ruling, you may be forced to design a Section 79 contract with a first year cash value?

MR. SHELLY: Actually, the tax leverage here depends upon the apparent cost of term insurance over the Table 1 cost. From this standpoint it appears that the best thing that can happen is for the president of the firm to be heavily rated, because it looks as if he is getting a great bargain. With this in mind, requests are made for special contracts with little or no cash values for four or five years because this would make a better-looking Section 79 product. I have seen some of the two-contract approaches. They try to keep the compensation the same as if you had one contract. This means that you have a yearly renewable term policy with, for example, a 55% commission, and then something which looks like an annuity contract with a very high commission. The combination is not attractive, except perhaps, for Section 79.

MR. MILLER: With respect to the dividend allocation under Section 79 products, currently the actuarial people at the IRS are focusing almost exclusively on the "permanent" portion of the policy and the derivation of the premium element for that portion. This produces some strong pressures to allocate the entire dividend to the "term" portion, because of uncertainties in the applicability of prior rulings which may arise through a change in the dividend scale.

MR. SHELLY: We allocate the entire dividend to the permanent part, which means that the employee is in effect paying for the dividend and getting it at the same time. This was apparently an acceptable solution. You could go the other way and have the dividend allocated to the group term part, in which

event it would go to the employer. It seems to me that you have the option as long as you keep the tax consequences straightened out.

MR. MILLER: In my studies of Section 79 products which are currently being marketed, I have seen both dividend allocation approaches used. I have also seen at least one approach where the dividend is divided between the "term" and "permanent" portions.

At this point, let us turn to the topic of policy loan interest rate. My company is among those which have adopted an 8% policy loan interest rate in the jurisdictions where this is permissible. Our reasons for taking this step can best be summarized by the following excerpt from an announcement which our Chairman of the Board sent to our Field Force last August, in order to inform them that we would be adopting the new program effective January 1, 1976.

> New York Life presently has more than $2.2 billion of policy loans outstanding, more than 17 percent of our total assets. These loans bring the Company and our policyowners an average return of only 5.08 percent compared with our current rate on new investments of over 9.75 percent.
>
> The result is that the three-quarters of our policyowners who are not borrowing on their policies are actually subsidizing the borrowing of the other 25 percent. Adopting a more realistic policy loan interest rate on new policies will be a significant step toward correcting this inequitable situation.
>
> This higher policy loan interest rate will result in a higher level of earnings for the Company. This will be taken into account in determining dividends payable on all life insurance policies with the higher loan interest rate. New illustrative dividend scales will show the higher dividends made possible by the new rate.

In 1973, the NAIC adopted a model bill which - in part - would permit companies to provide that all policy loans, including outstanding loans, could bear interest at a variable rate not exceeding a given percentage per annum, specified from time to time by the insurer. In material accompanying the bill, the NAIC observed that it would be highly desirable to have a uniform maximum rate throughout all the states and suggested that the starting point would be the specification of an 8% maximum. Although four states have passed legislation patterned after this model bill, five other states also have legislation specifically providing for a maximum policy loan interest rate of 8% or (in the case of one state) 8½%. In addition, there are 25 states whose laws do not prescibe a maximum policy loan interest rate, but which specify a maximum "contract rate" of 8% or more. Thus, the laws of 34 states would clearly seem to allow a variable policy loan interest rate with an 8% maximum but this isn't quite true in practice, as we will see a little later on. Let me also mention that, of these 34 states, 15 have legislation specifying a maximum rate of 6% in connection with reinstatement transactions.

During the course of our filing of new policy forms providing for the increased loan rate, we had some interesting adventures and some states required us to make further specific undertakings. Let me describe a few of these. First, our 8% loan rate for life insurance policies is approved in

only 32 of the 34 states to which I referred. In Kansas, although the insurance statute and the maximum "contract rate" seem to permit approval of policies containing an 8% loan rate, the Insurance Department is reluctant to do so because of the 6% rate in their reinstatement statute. A bill designed to specifically provide for a maximum 8% loan rate is now pending, and the Department is awaiting passage of this bill before taking any action on policy approvals. In North Carolina, while the basic enabling legislation also appears to be in effect, the Insurance Department has been deferring approvals of policies providing for an 8% loan rate pending further hearings on this subject.

Connecticut and Mississippi did not approve a "variable" rate with an 8% maximum. They required our policies to specify a fixed 8% loan rate, with no contractual reference to the possibility of a lower rate if declared by the company.

Colorado required assurances that the company would furnish it with full details concerning the rules and procedures which would be applicable with respect to any change in the loan interest rate before any such change was implemented. In similar fashion, Nevada requires a statement concerning the basis for determining the effective date of any declared change in the loan rate and also an outline of the method for determining such rate. This requirement is not a deterrent to approval but must be provided prior to declaring any change in the rate. On this same subject, Virginia went further and required us to endorse our policies so as to build in some specific requirements which are contained in the NAIC model bill. These are as follows:

1. The effective date of any increase in the interest rate shall not be less than one year after the effective date of the establishment of the previous rate.
2. The amount by which the interest rate is increased shall not exceed 1% per annum.
3. The Company shall give notice of the interest rate in effect when a loan is made and also send a notice of loan interest due.
4. The Company shall, at least 30 days prior to the effective date of an increase in the interest rate, give notice of such increase to owners of policies with loans outstanding 40 days before the effective date of the increase.
5. The Company shall give notice of an increase in the interest rate when a loan is made during the 40 days before the effective date of increase.

As I indicated earlier, a number of the states which permit an 8% policy loan interest rate have retained a 6% limit in connection with reinstatement transactions, including repayment of indebtedness in event of reinstatement. Thus, an anomaly exists which can create some administrative problems. For example, consider the situation where there is indebtedness outstanding at the end of the grace period of a premium in default and the company accepts payment of the overdue premium shortly thereafter, without any interest charge. A literal interpretation of such a law requires that the transaction be viewed as a reinstatement, and that the outstanding indebtedness bear interest at 6% from the end of the grace period to the date of "reinstatement" when the premium was paid. This accrued interest at 6% would then be added to the outstanding indebtedness as of the date of reinstatement and the new loan would thereafter be subject to interest at 8% until the next policy anniversary or interest due date.

The situation I have described so far relates to life insurance policies. Let me turn now to deferred annuities. No jurisdiction has a statute or regulation requiring that deferred annuities include a policy loan provision. Accordingly, on the theory that inclusion of a loan provision in deferred annuities is more favorable to policyowners, even where such a provision stipulates an interest rate in excess of the maximum loan rate specified for life insurance policies, we were able to obtain Insurance Department approval for deferred annuity contracts with an 8% policy loan provision in all of the 32 jurisdictions which have approved this rate for our life insurance policies plus 14 additional states. It is interesting that New York, with a 5% maximum loan rate for life insurance, is one of these 14 additional states which will approve an 8% maximum loan rate for deferred annuity contracts.

As to the outlook for changing the New York law to permit a higher than 5% loan rate on life insurance policies, I have heard a number of reports - some of them optimistic - but I shall believe it when I see it, and let me note that this is a legislative election year in our state.

As I indicated earlier, we have separate dividend scales for life insurance policies issued with an 8% policy loan rate. To my knowledge, every mutual company adopting an 8% loan rate has taken such dividend action and it seems quite clear that this will be the case in the future. As a matter of fact, several states did not approve our new policy filings until they had received assurances that we would make such a differentiation in dividend scales. The question of what is a proper dividend scale differential to reflect differences in policy loan interest rates can be approached in several different ways, which all boil down to appropriate reflection of the effect of the loan rate differential on after-tax investment yield. This obviously brings the question of proportion of actual loans to loanable funds into the calculation in some fashion. We recently made a study analyzing published information regarding illustrative dividend scales of five large mutual companies that have adopted an 8% loan rate. All of these companies appear to base their dividend scale differentials on a higher interest contribution for the dividends on policies with an 8% loan rate, as we do. Of the five companies, two appear to be using a 30 basis point differential (for policies with an 8% loan rate vs. those with a 6% rate) in the interest contribution; we also use 30 basis points currently. Two companies seem to have a 40 basis point differential and the fifth company seems to have a 45 basis point differential. For a Whole Life (or similar) policy issued to a male age 35, the effect of these differentials is to produce differences in interest-adjusted net payments and net costs per $1,000 which range from about $.20-.35 for 10-year interest-adjusted figures to about $.40-.60 for 20-year interest-adjusted figures.

Obviously, the virtual requirement that you have separate dividend scales if you are a mutual company wishing to adopt an 8% loan rate where permitted has considerable logistic implications. The need to produce additional sets of ratebooks, sales illustrations and other sales promotional material is certainly a time and cost item which must be weighed by a company considering such a step, and it is possible that this consideration will be particularly weighty in the case of smaller and medium-sized mutual companies.

To my knowledge, no stock company has yet moved to an 8% policy loan rate with respect to its non-par policies. Possibly, this reflects the fact that, for the same reasons that lead mutual companies to have higher dividend

scales for policies issued with an 8% loan rate, stock companies would be expected to charge lower premium rates for such policies issued on a non-par basis. I would not expect that the trauma of having two premium rate scales would be much different from that of having separate dividend scales in a mutual company.

As far as marketing considerations are concerned, I previously quoted from an announcement which our Chairman sent to our Field Force more than four months in advance of the effective date of our new program. This illustrates our feeling that, if you are going to move to an 8% loan rate, it is essential to inform your agents well in advance as to when the step will be taken and why it is being taken. Actually, we made it clear through various channels well before last August that this step was under serious consideration. Thus, full communication with your Field Force is necessary, but it will not always be sufficient. We know that some of our agents preferred that we not make the move to 8%; we believe that just about all of them appreciate why we felt it was necessary from a long-range standpoint, but that some of them wished that we were not among the earliest companies to make this move. In particular, since dividend scale differentials reflect far less than 100% borrowing of loanable funds, there is no doubt that for the insured who plans to borrow to the hilt (e.g. intends to follow a full minimum deposit scheme) the overall effect on him of having a policy with an 8% loan rate will be negative because the additional loan interest - even on an after-tax basis - will exceed the increase in dividend.

In any event, we have been quite satisfied from an overall standpoint with the reception of this new program by our Field Force. From present indications, there are no significant differences in sales levels - either upward or downward - in the jurisdictions where we have an 8% loan rate vs. those where we have a 5% or 6% rate. However, when we introduced the new program at the beginning of this year, we did notice some increased sales in the 8% states which reflected business dated back prior to January 1 so that the prior 6% loan interest rate would apply.

The situation in Canada is different from that in the United States in three important respects. First, there is in effect no variation in controlling laws and regulations by province such as the state by state variation we have on our side of the border. Second, there is no statutory maximum loan interest rate. Third, the maximum loan rate a company is using does not have to be specified in the policy; it can instead be specified in the loan agreement. At the present time, it appears that about half the companies operating in Canada follow this latter course. Currently, maximum policy loan interest rates specified in either policies or loan agreements generally fall in the range of 9% to 12%, and actual rates charged are generally in the range of 8% to 9%.

It has been suggested that a better approach to reflecting in pricing the effect of policy loans on a company's financial experience would be to have dividends under participating policies directly reflect the actual loan status of the particular policy. This could be implemented by using one dividend interest rate applicable to amounts not borrowed and another applicable to the portion borrowed. You can see that this approach is quite analogous to the type of policy loan provision which presently seems to be emerging for variable life insurance, under which the extent of borrowing directly affects the investment return used to determine changes in benefits under a particular policy. However, there presently seems to be a strong

body of legal opinion which states that use of this system with respect to dividends on participating fixed-benefit policies is not feasible because reductions, on account of borrowing, in dividends otherwise payable would be construed as being in violation of the statutes specifying maximum policy loan interest rates. It is also very difficult to see how this system could be adopted for use with respect to non-par policies.

MR. STANLEY: With respect to the variable policy loan rate, two elements seem important. One is the question of disintermediation. The other is the question of fairness to the policyholder. The question of disintermediation is common to both stock and mutual companies. The question of fairness to policyholders, it seems to me, is more difficult for stock companies than for mutual companies.

If the future is going to hold years in which there continues to be very wide swings in the new money rate as compared to the portfolio average yield, it is clear that both stock and mutual companies will be vulnerable to investment antiselection if the policy loan rate is materially lower than the new money rate since people can borrow when the investment opportunities elsewhere yield more than the policy loan rate, and repay the loan when the investments elsewhere yield less than the loan. The life company, therefore, is faced with the possibility of liquidating assets at a loss to make policy loans when new money rates are high, and being flooded with policy loan repayments and thus having money to invest when new money rates are low. In the face of such a possibility, it would seem the reasonable alternatives are either to change the traditional investment philosophy of the life insurance industry from long-term investments to short-term investments or to seek a policy loan rate which can vary with the new money rate in order to discourage the use of policy loans as a form of investment leverage.

For a mutual company it appears that this course does not provide a serious problem of equity or fairness because the dividend formula provides a means of returning to the policyholder the extra investment income generated by the higher policy loan rate. For a stock company, however, it is likely that, if in some years in the future it is necessary to utilize a policy loan rate of 8% in order to avoid investment antiselection by the policyholder who borrows against his policy, the extra investment income so generated will produce income greater than that contemplated in the initial product pricing and greater than that required for a fair profit on the policy.

The question then is, how can a stock company issue a policy with a policy loan interest rate considerably higher than the interest rate underlying the gross premium without creating what amounts to windfall profits to the company bearing in mind that a policy loan is a risk-free investment. At least in my own mind, I have not yet come to a satisfactory answer to this question. It appears perhaps that an excess interest provision in an otherwise non-participating policy might be a reasonable solution; however, such a provision would add to the administrative cost of non-participating insurance and also introduce the problem of equity between classes which does not now exist under guaranteed cost contracts.

In any event, should my own company's management request an opinion on the subject of introducing the variable loan rate into our policies, to quote Pope, I would advise -- "Be not the first by whom the new is tried, nor yet the last to cast the old aside."

MR. WALKER: Walt referred to the policy loan provision for VLI - a comment or two on that. The states that have adopted VLI laws have included a provision to the effect that the mandatory policy loan provision for fixed life insurance is not applicable to variable life insurance. These laws have been supplemented by regulations in some states. The Model VLI Regulation requires a loan provision in a variable life policy, but the provision must be so designed that if a policyholder borrows it is not to work to the disadvantage of the non-borrowing policyholders. This is achieved by recognizing that, on that portion of the cash value that has been borrowed, only the policy loan interest rate, less an appropriate deduction for expenses and contingencies, should be credited to the VLI policy while the loan is outstanding - and the separate account's investment experience should be reflected on only the portion of the cash value that has not been borrowed. This means that, contrary to what happens under a fixed life insurance contract (where on repayment you are in exactly the same position as if you had never borrowed), under a VLI policy, when the loan has been repaid you have a unique policy with benefits that are quite different from the benefits of any other policy, even though there is no loan outstanding. Under EVLICO's VLI policy, our policy loan interest rate is 4½%. With a 3% assumed interest return, the man who borrows is credited with just 3% on the portion of the value borrowed. The balance of 1½% is used for expenses and risk charges.

MR. MILLER: One of the large companies that has moved to an 8% loan rate for new issues has announced that they are seriously considering making this rate available to existing policyowners along with the benefits of the higher dividend scale planned to be paid on 8% versus 6% loan rate policies. I have not made up my mind as to whether this is a good, bad, or indifferent idea. Some of the reasons for it are obvious, but one thing about it that troubles me is what it might do to the overall philosophical definition of what constitutes a dividend class. There is also the question of whether there is a right to do something which might be interpreted as changing the rules in the middle of the game, even though the policyholder agrees to it. One prior reflection of this question occurred in the late 1950's when companies began to move over to systems of grading premiums per thousand by size of policy. A few of the mutual companies that adopted this approach for new issues began to grade dividends by size on existing policies, although most mutual companies did not. I think that the attitudes and reasoning behind whether to do something like that in that context are quite similar to the thinking you might go through in considering a proposal like this.

MR. WALKER: Would an election of this type be reversible upon request by the policyholder? This would obviously lead to a type of antiselection which you have to avoid. I would question whether you could successfully defend the election not being reversible.

MR. JAMES F. REISKYTL: Northwestern Mutual is considering offering all of its present policyowners the right to amend their contracts to the 8% policy loan rate. It seems clear that this action is legally defensible in that two parties to a contract have the right to agree to amend it. Most states have recognized this and are permitting the Company to make an offer to existing policyowners. Currently, we have no plans to permit policyowners to amend back to the original rates. As it takes the agreement of both parties to amend a policy, such a change would not be possible. We do not feel that any original pricing basis agreement exists between the policyowner and the Company. We have reflected policy size and sex differentials in the current

dividends for all policyowners when these pricing practices were introduced for new issues. The amendment offer is consistent with that practice.

There is a very practical reason for making this offer to existing policyowners in addition to one of improved equity. Offering existing policyowners the right to amend simply automates the action any policyowner could take on his own, but in the latter case, only those who know of it, ask for it, and can qualify for it will benefit from the more favorable rates. Since only the healthy lives can do this successfully if the Company does not offer the right to amend, mortality antiselection will be added to the borrower/non-borrower investment antiselection for those who remain. This possibility is quite real, especially if the agent's compensation is greater on the "new" sale than on the existing policy.

Northwestern has tested this program in a number of general agencies but has not yet made a decision to offer this amendment to all policyowners.

MR. WALKER: I have a question to ask Neal on the subject of term insurance. In a mutual life insurance company selling participating insurance, in theory, and hopefully in practice, each class of policyholders - class being broadly defined - is supposed to pay its own way. I have been brought up in the school of thought that in the pricing of term insurance, involving the premiums and dividends, the objective should be to have the term insurance class pay not only for the expenses and benefits incurred while the policies remain in the term class, but also for the extra mortality less any underwriting savings after conversion to permanent insurance. This extra mortality after conversion is to be borne by the term policyholder during the term period so as not to dilute the interests of the permanent life insurance class. Is that philosophy, in theory and in practice, applicable as well to a stock life insurance company selling non-participating term insurance?

MR. STANLEY: I would say that, in theory, there is no particular reason why you have to have equity between classes in a contract. You make a deal, and they buy it or they do not buy it; but, as a practical matter, I would not want term business to be a loss leader for my company. In practice then, we would certainly expect term policies to be self-supporting. Basically, when we calculate term rates, we calculate a pure term rate and then add an extra charge for renewability and an extra charge for convertibility. I do think that there are expenses associated with permanent insurance that you do not have with term insurance, and consequently the loading per thousand should be less. One of the big issues in term insurance today is the actuary's inability to know what the law requires with respect to deficiency reserves on renewable term insurance. I think our rates might be a bit different if that could be clarified beyond any doubt.